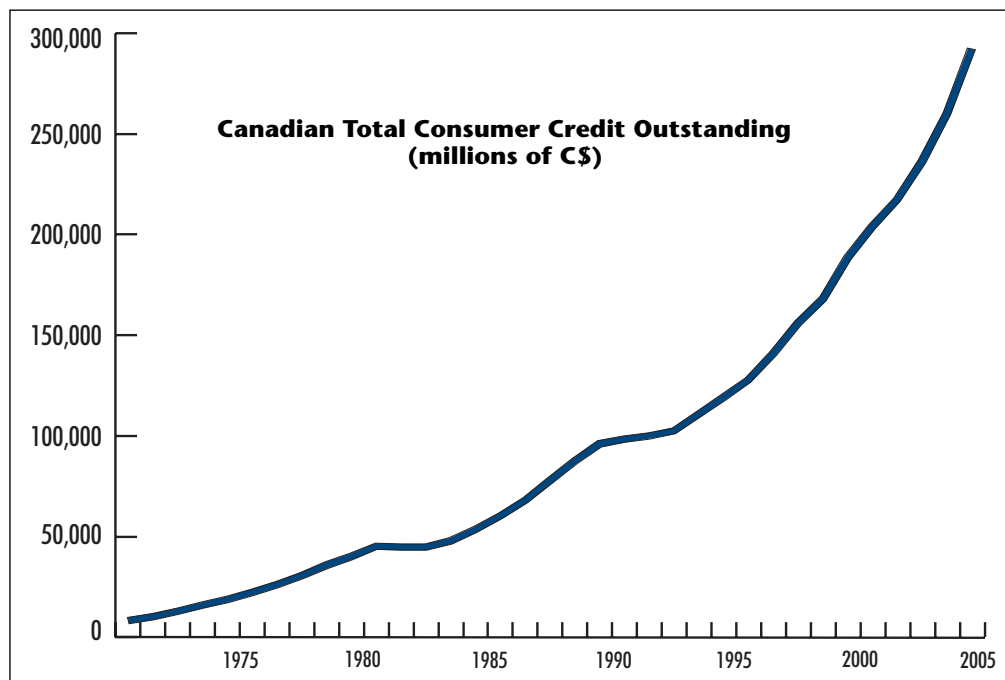


Chapter

10

Debt and Credit - A Matter of Interest

As Shakespeare wrote: "Neither a borrower nor a lender be." There are not many people who live their lives by that adage any more. The vast majority of Canadians are involved in the borrowing and/or lending of money.



Source: Statistics Canada

A debtor is someone who borrows. A creditor is someone who lends. Debt, therefore, is a liability — something that you owe. Credit is an asset — it has been loaned out and will, one hopes, be paid back.

These days, credit is quite readily available. One way in which it is available is through credit cards. A credit card is simply a means of making a payment through credit that has been previously approved by your credit card issuer. The company will have established a “limit” representing the maximum credit you have available. A credit card, then, represents a process by which to use money for purchases. The only catch is that you are, at least temporarily, using someone else’s money. When you use a credit card, some institution is providing you credit for the purchase — which of course means that you are taking out a loan and incurring a debt. You will have to pay the debt back, and this may also entail interest on the debt.

WHY BORROWING HAS INCREASED

Today people tend to be more willing to take on debt and, in many cases, higher levels of debt than people did 20 or so years ago. One reason for this is that there are more funds available for borrowing today and more readily available sources of credit.

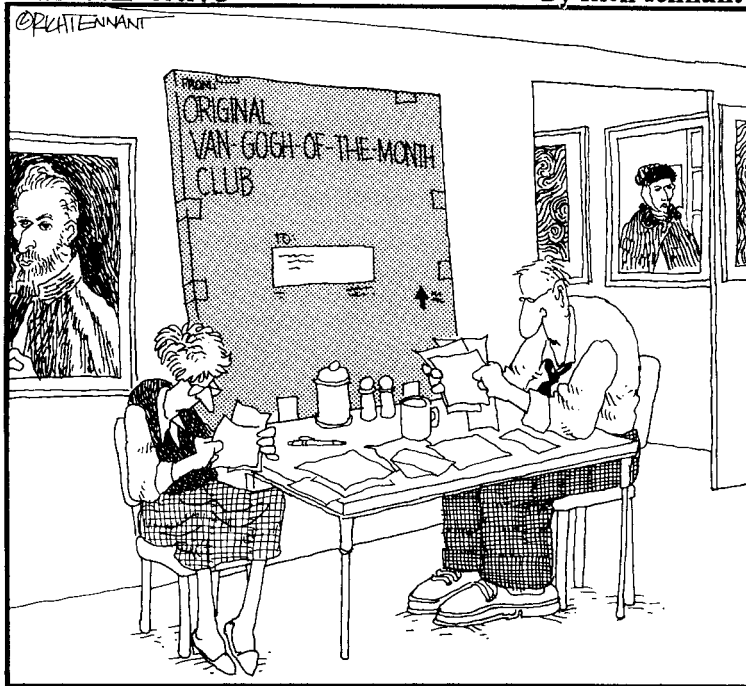
Another reason is that, by and large, people tend to be better off today. With higher incomes, people have a higher “ability to pay” or a greater ability to “carry debt.” For example, if you earn an income of \$60,000 a year and want to borrow \$5,000 for three years, you probably won’t have much of a problem because your income is such that you probably wouldn’t have trouble paying back both what you borrowed, called the “principal,” and the “interest” owing on the debt.

However, if you have an income of \$9,500 a year, you might be less willing, and less able, to borrow because you have a much lower “ability to pay” or “ability to carry the debt.” People often refer to “carrying a debt” or a “debt load.” That is because debt is usually considered somewhat of a financial burden. Not only do you face meeting your current day-to-day costs, but you also face the costs for what you bought in the past. You are, in essence, carrying past and present expenses into the future. In general, as people’s real incomes rise, their ability to pay increases, their ability to carry debt increases, and, therefore, their willingness to incur debt tends to increase.

Another reason for more borrowing today is due not only to higher incomes but also to higher prices. As prices rise, the need to borrow may increase — especially if prices rise at rates faster than incomes. Housing is an example. House prices have, on average, risen over the years to the point where very few people can buy a house today without taking on a mortgage.

The 5th Wave

By Rich Tennant



"I just don't know where the money's going."

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E-mail: the5wave@tiac.net

achieve the tax deductions that are possible (for example, borrowing for a contribution to a Registered Retirement Savings Plan). Furthermore, investment income tends to be taxed more favourably than regular income. This attracts some people to borrowing for investments to earn investment income.

Another reason for more borrowing today is the vast increase in the number of two-income households. In today's world, both partners are often working out of the home. This increases the household income and, thereby, the ability to carry debt.

Lifestyle is also a factor. It appears as though many people today want more things in their lives than people did in the past. There are many things in life that families often hope for today. These higher ambitions lead to the need for higher incomes, often require both spouses to work, and often lead to more debt. At the same time, it is also likely that many two-income households are working just to get by, let alone aspiring to "more" and "better."

For all of these and other reasons, there is more borrowing today by larger numbers of people. And people are incurring higher levels of debt. That is all the more reason for people today to have a thorough understanding of debt.

WHY DO PEOPLE BORROW?

- **Unexpected expenditures:** Maybe the car has broken down or the roof has started to leak. It is hoped that those of you who are reading this book will manage to be sufficiently prepared for these unpleasant surprises.

Another reason for more borrowing today is that, by and large, people understand debt and debt management better than in the past and therefore tend to be less nervous about it. (Some people should probably be a little more nervous, judging from the number of people who get into debt problems.) But, overall, knowledge tends to breed confidence, and this is probably true when it comes to borrowing, too.

Accompanying people's increased knowledge about debt and debt management is increased willingness to incur debt for investment purposes. In some cases, tax policies have also encouraged people to borrow for investment purposes in order to

- **The “big buys”:** Some items cannot be afforded out of current income and savings. They must be paid for with future income by taking on debt. Items in this category include such things as cars and houses.
- **Investment:** As we said earlier, some people borrow today to invest to try to increase the value of their savings. People will do this if they believe the return on the investment is worth the expense and risk involved in incurring the debt.
- **Education and training:** This is a form of investment. It is often referred to as “investment in human capital” — an investment in the improvement of your knowledge and skills. People will often borrow to pursue this type of investment because improved education and training often leads to higher paying jobs. Hence, the return from the investment can last a lifetime and is frequently worth the cost incurred.
- **Opportunities:** Sometimes opportunities present themselves that merit taking on debt to take advantage of the opportunity. For example, suppose one of your financial goals is to acquire a boat. Suppose further that you just happened to come across the deal of a lifetime — just the boat you want at a price better than you are likely to see again. You may conclude that going into debt to take advantage of the opportunity is worth the cost of the debt. Such a decision would be based on the fact that the amount saved by buying now would exceed the carrying costs on the debt. (Carrying costs refer to the total interest charges that you would end up paying on the debt.)
- **Rainy days:** A person may suddenly lose his/her job and find it necessary to incur debt. One must hope, though, that the troubled times are not so troubled that the ability to borrow is lost.

These are just some of the reasons people borrow. Some people can find very creative reasons for borrowing — perhaps reasons they shouldn’t. This is why debt must be used wisely.

We know why people borrow. Why do people (or companies) lend? There are people like parents, family, and friends who may lend to be helpful. However, for the most part, credit is received from other sources, sources that charge interest on the money you borrow.

People and companies lend because interest can be earned. If the interest received on a loan exceeds the rate of inflation, then the purchasing power of the funds can be increased. If interest couldn’t be earned on loans, or if the rate of interest was lower than the rate of inflation, very little lending would go on.

TYPES OF DEBT/CREDIT

The following is a brief list of some of the various forms of debt/credit. They tend to differ in terms of the reason for the loan.

- **Credit cards:** We have already referred to this form of debt. By and large, an institution that believes you are able to carry a certain level of debt and sufficiently responsible to pay off your debts will extend to you a credit card. This card will, in most cases, have a credit limit representing the amount of credit that the institution is prepared to extend to you. You can then use the card for payments up to the limit that has been extended.

Some credit cards operate so that you have to make a minimum monthly payment on the outstanding balance. This minimum amount will cover the institution's cost and return a profit. Remember that most credit cards such as VISA and Mastercard are issued by financial institutions. The credit that they are extending to you comes from the savings that have been placed on deposit in the financial institutions by savers. The savers are paid interest on their savings. Therefore, the financial institution must ensure that each month sufficient payment is received from the credit card holder to cover the interest paid to the saver, to cover the costs incurred in handling the transactions/accounts/etc., and to return a profit. The financial institutions earn a profit on the difference between the interest charges they incur (paid to their depositors) and the interest payments they receive from you on your outstanding credit balance.

You should be aware that if you pay your credit card bill in full by the due date, you usually do not incur any interest charges. Some institutions charge an annual fee or a fee for each transaction to cover their related expenses. Check this out when choosing which credit card to apply for.

- **Charge accounts:** This is the term used to refer to cards, virtually the same as credit cards, that are issued by retailers. You may, for example, have a "Bay

card," a "Petro-Canada card," or a "Canadian Tire card."

These cards are issued by the stores and companies to enable, and encourage, people to buy their products. They often charge relatively high rates of interest on unpaid balances.

Interest rates on credit cards tend to be higher — sometimes significantly higher — than interest rates on regular loans. For this reason, you shouldn't carry debt on credit cards for a long period of time. If you have used your credit card to the extent that it will take you more than a couple of months to pay it off, take out a regular loan to pay off the credit card balance. By doing so, you'll save a great deal of interest.

- **Consumer loans:** Loans are available from various financial institutions for a wide range of consumer purposes — to buy a car, for travel, for house renovations, for a boat, for a computer. These loans tend to be for periods from months to about 5–7 years.
- **Mortgage loans:** These are loans provided for the purchase of property. Mortgages will be explored more in a later chapter. For now, be aware that a mortgage is a loan that tends to be over a long period of time, generally



up to a maximum of 25 years. However, the terms of the loan, particularly the interest rate, have to be renegotiated at various points throughout the period of the mortgage. The total time over which the mortgage is taken out — 25 years, 20 years, 16 years, or whatever — is referred to as the amortization period.

The “term” of the mortgage refers to the period of time over which you have come to an agreement with the lender about the interest and other specifics of the mortgage.

The term may be for six months, one year, two years or anywhere up to 5–7 years. It is uncommon these days for a financial institution to be willing to negotiate the terms of a loan for any more than 5 or 7 years, although there are some possibilities. The future beyond that usually holds too much uncertainty.

- **Business loans:** Some people borrow funds to start, improve, or expand a business.
- **Installment buying:** Purchases can be paid in installments. Generally, if you purchase something through installments, you will have to pay interest charges, but you get the use of your purchase while you are paying for it.

These, then, are some of the various forms of credit/debt. Now let’s look at possible sources of credit.

SOURCES OF CREDIT

Credit can be obtained from a wide range of sources, including the following:

- **Family and friends:** Some people make a point of never borrowing from family or friends because they feel that if the debt couldn’t be repaid they would risk the relationship. However, many people do acquire funds in this manner. Perhaps the best recommendation is to make the loan/debt relationship as formal as possible.

- **Financial institutions:** This is the primary source of credit in our economy. Banks, trust companies, insurance companies, and brokers all are in a position to extend credit.
- **Mortgage and loan companies:** There are some companies that are in the business of providing loans. They tend to provide loans to those who represent higher levels of risk, those who cannot obtain credit from the financial institutions noted above. But because their clients represent greater risk, the interest rate charges also tend to be higher.
- **Retailers:** By providing charge cards, the retailers (such as The Bay, Imperial Oil, and so forth) are providing credit to those who buy their products using their charge cards.
- **Yourself:** For example, people are frequently unaware that they can borrow from the funds that have been accumulated in insurance policies. Before looking to other sources, make sure you look to see if you have any of your own funds from which you can borrow.
- **Credit unions:** In many workplaces, employees can borrow from credit unions where pools of funds have been accumulated by savings deposited by employees in return for interest.

To this point, then, we have looked at the reasons people borrow and at forms and sources of credit. Next we'll explore the cost of credit.

THE COST OF CREDIT

The cost of credit is the amount of interest that is paid on the loan. But the amount of interest that is paid on a loan is determined by more than just the rate of interest.

Another extremely important determinant is the period of time over which debt is paid back. If you borrow funds over a shorter period of time, you will pay less total interest than if you borrow over a longer period of time. Perhaps the best illustration of this is a mortgage. Look at the following three tables.

\$60,000 MORTGAGE

15-year Amortization

| Interest Rate | Monthly Payment | Total Repaid | Total Interest Payment |
|---------------|-----------------|--------------|------------------------|
| 4% | \$443.81 | \$ 79,886 | \$19,886 |
| 6% | 506.31 | 91,136 | 31,137 |
| 8% | 573.39 | 103,210 | 43,210 |
| 10% | 644.76 | 116,057 | 56,057 |

20-year Amortization

| Interest Rate | Monthly Payment | Total Repaid | Total Interest Payment |
|---------------|-----------------|--------------|------------------------|
| 4% | \$363.59 | \$ 87,262 | \$27,261 |
| 6% | 429.86 | 103,166 | 43,166 |
| 8% | 501.86 | 120,446 | 60,447 |
| 10% | 579.01 | 138,962 | 78,963 |

25-year Amortization

| Interest Rate | Monthly Payment | Total Repaid | Total Interest Payment |
|---------------|-----------------|--------------|------------------------|
| 4% | \$316.70 | \$ 95,010 | \$ 35,011 |
| 6% | 386.58 | 115,974 | 55,974 |
| 8% | 463.09 | 138,927 | 78,927 |
| 10% | 545.22 | 163,566 | 103,566 |

Note that if \$60,000 is borrowed at 4% interest and paid back over 15 years, the total interest paid is \$19,886. If the \$60,000 is paid back over 20 years, the total interest payment is \$27,261. The same loan amount — \$60,000 — costs \$7,375 more if it is paid back over 20 years as opposed to 15 years. It is obvious that time is as important as the rate of interest.

You should always know the total cost of a loan. The principal is the amount that you borrow. For example, if you borrow \$1,000 for one year at 6% interest, the loan principal is \$1,000. The interest on the loan is the amount that you pay back over and above the principal. For the loan just described, the interest would be \$60. Therefore, you would pay back a total of \$1,060.

The cost of the loan will also be affected by the source of credit that you are able to use. If you are able to show a history of paying off your debt, you will probably be able to get a fairly competitive interest rate. However, if because of your credit history or financial resource situation you

can't obtain credit from the lower cost sources, you may have to go to other sources where costs are higher.

Whenever you consider taking a loan (or using credit), ask what the interest rate is and how much total interest you will be paying. Reliable creditors will not hesitate to give you honest, accurate information. And get everything in writing.

Financial institutions will often base their loan rates on something called the "prime rate" of interest. The prime rate is the rate of interest that the institutions charge to their largest, most reliable customers — often large corporations.

When you go into a bank or other institution to negotiate a loan, you will meet

with a loans officer. He or she will discuss your situation with you, take down the details of your request, ask questions related to your credit worthiness (more on this in a moment), and so forth. The loans officer will also organize a credit check — that is, a check on your credit rating (more on this, too, shortly) — and tell you the rate of interest that you will be charged for the loan. As a new borrower, you will not likely get a loan at the lowest rate available.

Don't borrow from the first place you visit unless you have some special reason (for example, maybe your family banks there and you want to as well). Be sure to comparison shop for credit. Financial institutions do compete with one another, and there is a chance that another institution may offer you a loan at a lower rate of interest. Financial institutions will often be prepared to match rates offered elsewhere.

Another important point to note is the down payment. This refers to the amount of money you can pay at the time of purchase versus how much you have to pay through borrowing. For example, suppose you are going to spend \$3,000 on a car and you have \$1,200 available. You can use the \$1,200 as a down payment and borrow the remainder. (Borrowing is often referred to as financing — you put down \$1,200 and finance \$1,800.)

Therefore, the total cost for the car will be \$3,000 plus whatever interest you have to pay on the borrowed money (that is, interest on the \$1,800). The key point is that the higher your down payment on any purchased item, the less you will have to borrow (finance) and the less your total cost will be.



For your own information, find out the following:

1. The difference between paying 3% for a \$2,000 loan over two years versus paying 5% for the same loan for two years.
2. The difference between paying off a \$3,000 loan at an interest rate of 7% over two years versus paying off the same loan over four years.
3. The difference in total cost for a \$4,000 car (a) with a \$2,000 down payment and financing \$2,000 over three years at 4% versus (b) financing the entire \$4,000 over four years at 8%.

So, let's summarize the key points so far:

- know the total cost of any loan (principal + interest)
- don't carry debt on credit cards; if possible, take out a regular loan to pay off the credit card balance
- comparison shop for the best rate
- decide on the term of the loan — the shortest term you can afford may be the best since it will cost you less overall
- put down as large an amount as you can to lower the amount you will have to borrow, the interest you will have to pay, and, hence, the total cost to you



Suppose you want to buy a brand new car for \$15,000, and you are going to finance the entire purchase. Explore the different rates offered by different sources of credit.



Within a group, discuss the influences that tend to lead to impulse buying. Discuss possible techniques that a person could use to resist impulse buying.



Suppose you are a creditor with money available to lend. Someone comes to you who wants to buy a boat for \$22,000 and borrow \$18,000 from you to do it. What information would you want to know prior to deciding whether or not to provide the loan?



Suppose that you want to prove to someone that you are a responsible individual. List things about yourself, or that you have accomplished, that would serve as evidence of your responsibility.

Above all, do not be afraid to ask questions. Your financial affairs are too important for you to worry about whether or not you sound foolish. Besides, many adult Canadians do not understand much about financial matters, and asking questions will probably earn you the respect of a creditor who will be pleased to see how thorough you are — it will be a sign that you will likely be responsible about paying the money back.

The following are some questions you should be sure to ask when taking out a loan.

- Is the interest rate on the loan fixed or does it vary?
- What are the first and last payment dates?
- Can I pay off the loan at any time? If so, is there any penalty for doing so?
- Are there fees other than interest payments?
- How frequently will interest on my loan be calculated? What happens, or what can be done, if I miss a payment or am unable to make one for any reason?

There are other questions that you may have. Don't be afraid to ask!

CREDIT WORTHINESS

If you want a financial institution to lend you money, you will have to prove that you are able and likely to pay back the loan. This is commonly referred to as your “credit worthiness.” Credit worthiness is an assessment of your ability to take on, carry, and pay back debt. The 3 Cs of credit worthiness are capital, character, and capacity.

CAPITAL

This refers to the assets you have that the creditor could draw upon if they were ever needed to pay back the loan. This would include any equity you have in a house (that part of the house that you own — the value of the house minus the mortgage), stocks, bonds, cars, and so on. As a borrower, you would probably not have any intention of using these to pay back the loan. However, if for some reason you were unable to make the payments on the loan or pay it back in full, then the creditor would like to know what assets you own that you could sell (liquidate) to obtain the financial resources necessary to pay back the loan. Assets that you use to “secure” (prove that you can pay back) a loan are referred to as “collateral.”

CHARACTER

A creditor wants to have some indication that a borrower is a responsible individual who will honour his/her debts and make regular payments. When you apply for a loan, the loans officer will meet with you and try to assess your character and how responsible and reliable you are likely to be.

Some of the questions that you have to answer on a loan application may surprise you. You may be asked how long you have worked at your current job; how long you have lived at your current address; and whether you have incurred any other debts. Are you married? Do you have dependents?

Being with an employer for quite a while, living at the same address for some time, being married, or having children tend to represent stability and responsibility. This doesn't mean that you can't get a loan if you aren't married with two kids and haven't worked and lived at the same place for ten years. It does mean that if you have changed jobs frequently or moved from place to place, you may encounter some hesitation from loans officers when you apply for a loan.

CAPACITY

The creditor will also be interested in your ability to carry debt. Do you have sufficient income to cover the monthly payments? Have you taken on a level of debt that is too high and that jeopardizes your ability to pay? How much cash do you have? How much do you owe? Your assets and your income level will be compared with your carrying costs on all other debt so that the creditor can assess whether or not to extend a loan to you.

These, then, are the 3 Cs by which your credit worthiness will be assessed. However, regardless of your credit worthiness, your credit rating can overpower it — particularly if you have a less than favourable rating.

CREDIT RATING

Many people are unaware that a credit rating system even exists. But it does. It exists because all of those who are in the business of extending credit are pleased to jointly share information about those individuals who have not been responsible about repaying their debts.

A credit bureau exists and operates on the basis of keeping a record of those individuals who have proved to be less than responsible in paying back debt. If you were to purchase something from a store on a credit card and then not pay the charges on the card, the institution that issued the card to you and didn't receive payment will notify the credit bureau. The credit bureau will record that information and make it available to other creditors that contact the bureau.

Most creditors will make ongoing and serious attempts to get the borrower to repay the loan before filing information with the credit bureau. After all, their primary interest is in getting their loan back. That is why it is always impor-

tant to contact the creditor if you are having problems repaying a debt and try to work out a repayment plan. Creditors will usually try to accommodate your situation. However, if they don't hear from you, they may simply file the information with the credit bureau.

It is important to achieve and protect a good credit rating. A bad credit rating can come back to plague you time and time again. It can be terribly disappointing to reach a point in your life when you want to do something such as buy a home only to discover that a poor credit rating stops you from getting a mortgage.

Often people who are having trouble meeting their debt obligations will hear from a collection department or agency before information is filed with the credit bureau. If you are contacted in this way about a delinquent loan, accept it as a warning and deal with the matter immediately.

Even if you don't have any intention of borrowing, you never know when the need to do so may unexpectedly arise. It is always wise to maintain an ability to borrow, which includes maintaining a good credit rating.

The following are some tips for maintaining a good credit rating:

- pay your debts
- don't sign any kind of credit contract until you have read it thoroughly, understand it, and know what you are getting into
- never sign a blank form of any kind

- always try to pay your bills on time
- contact your creditors if you are having trouble making payments
- deal with reputable creditors (they should have a good credit rating, too)
- be cautious about co-signing for a loan

This last point requires some explanation. A person who is unable to get a loan can sometimes get a loan if someone co-signs the loan. A co-signer agrees to take on the responsibility for the loan should the borrower not make the payments. This is a serious responsibility. A parent may co-sign a loan for a child if the child is still relatively young, with limited financial resources, and wanting to buy an item such as a car. Think carefully if you are asked to co-sign for a loan.

Establishing a good credit rating can be a particular challenge for young people. You can't establish a good credit rating because you can't get a loan, which would enable you to establish a good credit rating. (This is not unlike needing experience to get a job, yet being unable to get a job due to lack of experience.)

In order to establish a good credit rating, a young person might decide to get a credit card from a retailer, for example, use it when making purchases, and then pay off the bills promptly and fully. In this way, a credit rating can begin to be

established even at a relatively young age. But again, self-discipline must be exercised in using the card.

So what are the advantages and disadvantages of using credit and incurring debt?

THE ADVANTAGES AND DISADVANTAGES OF CREDIT



ADVANTAGES

- You can enjoy/use something (for example, a car, a house, a vacation, education, new clothes) as you are paying for it out of future income.
- Credit enables you to handle emergencies and unexpected costs due to illness, accident, loss of work, breakdown of a car, and so forth.
- Credit can enable you to pay more to buy goods of higher quality that will last longer and that may be a wiser consumer choice.
- You can take advantage of sales. (Just make sure that the amount you save through the sale is more than it costs you in interest.)

- Credit provides a record of your expenses. Credit card issuers provide a monthly statement, which itemizes all of your expenditures made with the credit card.
- Credit can simplify the payment of many bills by enabling you to borrow one amount to pay them all off and then carry a single debt with a single payment.



DISADVANTAGES

- Credit can encourage you to live beyond your means and get you into financial difficulty.
- Credit can mean that your future income will be tied up in paying past debts and that you will be unable to undertake new expenditures.
- Credit can be expensive since the interest must be added to the price.
- Credit can enable impulse buying, which may lead to unwise consumer choices.
- Credit cards for a particular store may lead you to do less comparison shopping since you may shop where you have the card rather than where the best deal is.
- Using credit will mean that you will have less reserve for unforeseen emergencies.

SIGNS THAT YOU MAY BE IN DEBT TROUBLE

You are...

- finding it difficult to save anything
- continually short of funds
- using your savings to pay debt costs
- near your credit limit on all or most of your accounts
- missing payments or due dates for your bills
- always making only the minimum payments on your accounts
- unaware of how much you owe
- worrying a lot about money
- borrowing money to pay off debt costs
- having to borrow money to meet your week-to-week or month-to-month expenses

WHAT TO DO IF YOU HAVE A DEBT PROBLEM



- Perhaps the most important piece of advice is to face up to your financial problems and start to do something about them. Don't try to handle it all alone. If you have close personal friends or family in whom you confide, do so and seek their advice and support. They can also help you accept the reality of a bad situation. You will probably be surprised at how many people are willing to help and co-operate to see you over a rough period or particular financial hurdle.
- Contact your creditors. Don't simply start missing payments. Most will readily try to help you get out of the hole you are in. After all, they have an interest in your ability to pay. Work out a new payment schedule with them. You will probably be surprised at how co-operative most creditors will be.
- Put all of your credit cards away to avoid getting into worse trouble.
- Consider a consolidation loan for your debts. In this way you can turn a number of payments into a single payment that may be less than the total of the other payments combined. If you are carrying debt on credit cards, the interest you will pay on a regular loan will usually be much lower than that on a credit card balance.
- Consider a second job to see you over the hurdle.
- Cash in some investments or savings to lower your debt position. The costs you pay on your debt will frequently exceed the interest you earn on your investments, and it may pay to give up the investment in order to do away with the debt.
- Stop all further borrowing. No sense digging a deeper hole.
- Seek some professional advice and counselling
- Re-evaluate your lifestyle. What can you give up to free up some money to help you pay your debts?

You'll recall that one reason for using credit is to make major purchases. In the next chapter, we'll look at some major expenses many of us will face during our lifetime.